

ARMY AUDIT AGENCY REPORT



INSPECTOR GENERAL
DEPARTMENT OF DEFENSE
400 ARMY NAVY DRIVE
ARLINGTON, VIRGINIA 22202-2884



March 1, 1997

MEMORANDUM FOR UNDER SECRETARY OF DEFENSE (COMPTROLLER) AND
CHIEF FINANCIAL OFFICER
DIRECTOR, DEFENSE FINANCE AND ACCOUNTING SERVICE

SUBJECT: Endorsement of the Disclaimer of Opinion on the FYs 1996 and 1995 Army Principal Financial Statements (Project No. 6FI-2020)

The Chief Financial Officers Act of 1990, as amended by the Federal Financial Management Act of 1994, requires financial statement audits by the Inspectors General. On May 17, 1996, we delegated to the Army Audit Agency (AAA) the audit of the FYs 1996 and 1995 Army principal financial statements. Summarized below are the AAA opinion letter on the FYs 1996 and 1995 Army principal financial statements and the results of our review of the audit conducted by AAA. We endorse the disclaimer of opinion expressed by AAA (see the Enclosure) in its audit of the FYs 1996 and 1995 Army principal financial statements.

Endorsement of the Disclaimer of Opinion. The AAA disclaimer of opinion on the FYs 1996 and 1995 Army principal financial statements, dated February 21, 1997, stated that AAA was unable to express an opinion on those financial statements. We concur with the AAA disclaimer of opinion.

The primary reason AAA was unable to express an opinion was that the accounting systems, and other systems that interface with the accounting systems, were not designed for financial statement reporting, and therefore cannot produce reliable and auditable financial statement data. Other reasons for the AAA disclaimer of opinion were:

- o The processes used to collect, classify, and value fixed asset data (translating data on quantities of assets into reported dollar values) did not produce reliable and auditable amounts in the Statement of Financial Position.
- o Systems, procedural, and policy problems prevented the auditors from attesting to the reported values for accounts payable, and also for contingent and other liabilities.
- o Accounting systems did not produce subsidiary ledgers showing the detailed transactions that made up the summary amounts reported for expenses in the Army's financial statements.

Inadequate accounting systems resulted in disclaimers of opinion for the FYs 1991 through 1995 Army principal financial statements. Inadequate accounting systems continued to exist in relation to the FY 1996 financial statements.

Internal Controls and Compliance With Laws and Regulations. Internal controls did not fully ensure that the Army's financial statements contained no material misstatements. As a result, the risk of material financial misstatements was high. The Army and the Defense Finance and Accounting Service have recognized many of the financial reporting weaknesses and reported

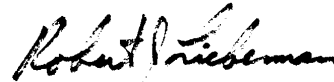
them in their FY 1996 annual statements of assurance on management controls. AAA audit work did not disclose any instances of unreported failures to comply with laws and regulations for the Army's financial statements.

Review of Army Audit Agency Work. To fulfill our responsibilities for determining the accuracy and completeness of the independent audit conducted by the AAA, we:

- o reviewed the AAA approach and planning of the audit, and
- o monitored the progress of the audit at key points.

We also performed other procedures deemed necessary to determine the fairness and accuracy of the audit approach and conclusions.

We conducted our review of the AAA audit of the FYs 1996 and 1995 Army principal financial statements from May 17, 1996, through February 21, 1997, in accordance with generally accepted Government auditing standards. We found no indication that we could not rely on the AAA disclaimer of opinion on the Army principal financial statements and the related AAA evaluation of internal controls and compliance with laws and regulations.



Robert J. Lieberman
Assistant Inspector General
for Auditing

Enclosure



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Secretary of the Army

In accordance with the Chief Financial Officers Act of 1990, as amended by the Government Management Reform Act of 1994, the Army prepared the accompanying Principal Financial Statements for the fiscal years ended 30 September 1996 and 1995. As delegated by, and in coordination with, the Inspector General, DOD, we were engaged to audit the statements, including an evaluation of related internal controls and compliance with laws and regulations.

We were unable to express an opinion on the Army's Principal Financial Statements for the fiscal years ended 30 September 1996 and 1995. The reasons for our disclaimer were inadequate accounting systems, insufficient audit trails, and unreliable amounts for several types of assets, liabilities, and expenses. Procedural and compliance problems also contributed to the lack of reliable amounts in the Army's financial statements. In this report, we explain our disclaimer reasons plus some other reporting problems. We also cite areas where the Army and the Defense Finance and Accounting Service are making progress.

Internal controls weren't fully effective to ensure there were no material misstatements in the financial statements. As a result, the risk of material financial misstatements is high. The Army and the Defense Accounting Service have recognized many of the associated financial reporting weaknesses and reported them in their FY 96 annual assurance statements. Our audit efforts didn't disclose any instances of unreported failures to comply with laws and regulations related to the Army's financial statements. We will present details on these matters in our separate report on internal controls and compliance with laws and regulations.

Financial data in the Overview and the Supplemental Financial and Management Information sections of the Army's FY 96 Annual Financial Report was derived from the same sources as the financial statements and, therefore, may not be reliable.

To the extent possible, we performed our work in accordance with generally accepted government auditing standards and Office of Management and Budget Bulletin 93-06 (Audit Requirements for Federal Financial Statements). However, as noted in the body of our report, there were significant limitations to the scope of our work.

Reasons for Disclaimer

Our audit work showed that the Army continues to experience major financial reporting problems which precluded us from rendering an opinion on its financial statements. Specific reasons for our disclaimer were inadequate accounting systems, insufficient audit trails, and unreliable amounts for several types of assets, liabilities, and expenses. These problems are being worked on, but complete solutions aren't likely for several years to come.

The Army reported \$201 billion in assets, \$25.3 billion in liabilities, and \$64.7 billion in expenses in its financial statements for FY 96. Building on prior year audit results, we audited major portions of the reported assets and liabilities. Accounting systems problems precluded us from auditing reported expenses. Accounting systems and procedural problems also precluded us from attesting to the reported values for much of the Army's assets and liabilities. The following paragraphs briefly summarize our results. Complete details on these subjects, including specific recommendations, are in the supporting audit reports to be issued separately.

ACCOUNTING SYSTEMS

The primary reason that we couldn't render an opinion on the Army's financial statements is that the accounting systems, and the systems which interface with the accounting systems (such as the Army's logistics and contracting systems), weren't designed for financial statement-type reporting—and, therefore, can't produce reliable and auditable financial statement numbers. The Defense Accounting Service owns and operates most of the systems used to account for the Army's resources, and it's working on a new accounting system intended to resolve this problem. However, the new system probably won't be fully fielded until after the turn of the century.

ASSETS

As in prior years, we found that the reported total for fund balance with Treasury (\$31.2 billion for FY 96) was reliable. However, the total included an abnormal (\$-134 million) fund balance with Treasury for non-entity assets. We also found that the reported quantities of fixed assets were generally accurate. However, the processes used to collect, Quantity data into reported dollar values) didn't produce reliable and

auditable numbers in the Statement of Financial Position. We describe the most significant problems we found in the following paragraphs.

Inventory, Net. The reported value for inventory, net (\$37.7 billion for FY 96) was misstated by an unknown but probably material amount because the assets weren't properly valued—holding gains and losses weren't recognized, asset prices weren't current, and asset stockage categories were misstated. We also noted that this line consisted mostly of assets which don't appear to meet the definition of inventory. Instead, these assets probably should be reported as property, plant and equipment or separately as war reserves. This is a DOD-wide policy issue and will be addressed by the Inspector General, DOD.

Property, Plant and Equipment, Net. We weren't able to attest to the reported value for property, plant and equipment, net (\$124.9 billion for FY 96) because the following sub-elements were misstated by unknown amounts:

- The reported value for military equipment (\$80.9 billion) was misstated by an unknown but probably material amount. Physical accountability of equipment at using units appeared adequate, but the prices used to value this equipment weren't current. Furthermore, some units' equipment reports weren't accurate or complete, and most reports weren't based on DOD-specified asset reporting thresholds. The reported value for military equipment was also misstated because the contractor reports—used to account for equipment held by contractors—weren't complete or accurate.
- The reported value (\$27.5 billion) for real property (land; and structures, facilities, and leasehold improvements) was misstated by an unknown but probably material amount because Army and DOD reporting guidance wasn't clear and wasn't consistently implemented. Furthermore, real property assets were understated by an unknown but probably material amount because the Army's financial interest in State National Guard facilities wasn't recorded as an asset.
- The reported value for construction in progress (\$9.6 billion) was misstated by an unknown but probably material amount because (i) the portion pertaining to government-furnished materiel (\$3.3 billion) was based on contractor reports which weren't accurate or complete, and (ii) the amount reported for Army National Guard construction in progress (\$1.7 billion) included an unknown amount for completed projects.

Other Entity Assets. The reported value for other entity assets (\$5.5 billion for FY 96) was misstated by an unknown but probably material amount because it was derived from contractor reports which weren't complete or accurate, and included large amounts for equipment items which didn't belong to the Army or were otherwise already accounted for.

LIABILITIES

By recognizing liabilities in its statements for FY 96 that it had previously only disclosed in footnotes, the Army made significant progress reporting its actual liabilities. However, systems, procedural, and policy problems prevented us from attesting to the reported values for accounts payable, and also for contingent and other liabilities. We anticipate additional progress in the near term on contingent and other liabilities, but the problems with accounts payable are likely to take longer to resolve. Here are the major problems.

Accounts Payable. The reported balances of accounts payable covered by budgetary resources for Federal and non-Federal entities (\$3.9 billion for FY 96) weren't reliable, and existing accounting systems and procedures precluded the determination of reliable values for these accounts. Accounts payable frequently aren't recorded (i) when goods or services are received, (ii) for year-end unpaid invoices on Defense-administered Army contracts, and (iii) for progress payment holdbacks. Furthermore, the Defense Accounting Service makes corporate-level adjustments to the Army's accounts payable which, because of procedural problems, distort rather than improve the reported numbers.

Other Liabilities. Although the Army recognized \$15 billion in other liabilities not previously recognized—a major improvement over prior years—not all reportable liabilities have been identified and properly valued. Consequently, we can't attest to the reliability of the contingent and other liabilities presented in the Army's statements.

EXPENSES

Our prior audit results showed that the accounting systems don't produce transaction sets (subsidiary ledgers) showing the detailed transactions that make up the summary numbers reported for expenses in the Army's financial statements. Therefore, we didn't attempt to audit the expenses reported in the Army's statements for FY 96. We have **Recommended that changes be made to the Army's accounting systems to remedy this problem. The Defense Accounting Service (the owner and operator of the Army's primary accounting systems) acknowledged the**

deficiency, but it's working on a new accounting system to replace those currently in use, and has decided to invest all of its available systems resources in the new system. Consequently, the existing accounting systems won't be changed, and this problem won't be resolved until the new accounting system is fielded.

Other Reporting Problems

Our audit work disclosed other problems which don't preclude us from rendering an audit opinion, but which must be resolved to ensure the affected data is properly presented in the Army's financial statements.

Assets Under Capital Lease. The Army's overseas real property holdings, totaling about \$5 billion for FY 96, were misclassified as assets under capital lease and should have been reported in the normal real property accounts. This property was reported as assets under capital lease based on guidance from the Under Secretary of Defense (Comptroller). In our opinion, this guidance runs counter to generally accepted accounting principles. Also, some of the Army's real property holdings in Europe, which were confiscated from the German Government after World War II, or funded by other governments, weren't properly reported.

Natural Resources. The Army's reported value for natural resources (\$1.7 billion in standing timber assets for FY 96) may be overstated. The reporting guidance for these assets isn't clear, and wasn't implemented consistently. Moreover, reported values include timber which can't be harvested.

Operating Materials and Supplies. Based on guidance from the Under Secretary of Defense (Comptroller), the Army expensed the inventories of repair parts owned by its combat divisions and separate brigades—but it's possible that these inventories should have been reported as assets. The inventories appear to meet the definition of operating materials and supplies, so expensing them may understate the Army's total assets (these units are authorized to stock parts inventories worth about \$800 million). This is a potential DOD-wide problem, and its resolution will be addressed by the Inspector General, DOD.

Progress Areas

The Defense Accounting Service has the lead on the ongoing effort to develop the new accounting system intended to resolve many of the problems noted in this report. And, the army has been actively working with the Defense Accounting Service on the accounting system

Development project. The Army has also taken steps to resolve the other financial reporting problems that it can fix by itself, and, as discussed in this section, we found that several of these problems were recently resolved.

Additionally, the Office of the Assistant Secretary of the Army (Financial Management and Comptroller) routinely holds Armywide video teleconferences in which financial problems are monitored and pursued. This office is also engaged in numerous partnering arrangements with other senior Army and DOD managers on functional and financial management improvement initiatives and problem-solving projects.

FINANCIAL REPORTING INITIATIVES

We discuss some of the Army's most noteworthy financial reporting initiatives in the following paragraphs.

Corps of Engineers Financial Management System. In May 1996, after a joint, preliminary test at an Army installation, the Under Secretary of Defense (Comptroller) directed the Defense Accounting Service to proceed with efforts to adapt the U.S. Army Corps of Engineers Financial Management System for use as the General Fund accounting system for the Army and some other DOD entities. The basic system is being fielded to Corps entities, and appears capable of meeting the Chief Financial Officers Act's financial management and reporting requirements. Adapting the system to the General Fund will entail much work, but its apparent success in the Corps makes it a meaningful candidate for resolving the Army's General Fund accounting problems.

Revaluing Unserviceables. In prior years, the lack of a method for revaluing unserviceable, reparable assets was one of the reasons we disclaimed an opinion on the Army's statements. During the current reporting cycle, the Army agreed to a method for revaluing these unserviceables, and this disclaimer point was resolved.

Real Property Integrated Process Team. Recognizing the magnitude and cross-cutting nature of the problems in financially accounting for real property, the Army initiated the establishment of a DOD-wide Real Property Integrated Process Team. The Team's objectives include defining data elements needed in real property systems for financial reporting, recommending needed policy changes to DOD, and identifying the process for integrating the Defense Property Accountability System with the various real property management systems. The team has met several times since being formed in FY 96 and plans to hold future meetings at least twice a year until financial reporting problems are

resolved. The team's goal is to have real property data loaded into the Defense Property Accountability System by the end of FY 98.

Asset Reporting. In response to prior audit recommendations, the Army's logisticians have undertaken a number of actions to rectify military equipment reporting problems. These actions include the initiation of a contractor-assisted effort to reduce mismatches between unit property records and the Continuing Balance System-Expanded (the system used as the source of data for reporting equipment in use at tactical units), the establishment of an Integrated Process Team chartered to improve the accuracy of the records on in-transit equipment, and aggressive interactions with the Defense Accounting Service to fund and implement changes to logistics systems accounting applications so that they properly report Project Manager-owned assets, as well as unserviceable, obsolete and excess assets. These efforts, planned for completion in FY 97 through FY 99, should remedy many of the Army's asset reporting problems and enhance the reliability of the asset values reported in the Army's financial statements.

Government-Furnished Property. In recognition of the extent and complexity of the problems which hinder financial accountability for government-furnished property, the Assistant Secretary of the Army (Financial Management and Comptroller) has hired Coopers and Lybrand on a series of engagements designed to bring a commercial perspective to the problem, and help determine needed changes.

Problem Disbursements. The Army continued its efforts to reduce the amount of problem disbursements. As of 30 September 1996, the Army reported a negative unliquidated obligation balance of \$133 million—the lowest since it began keeping statistics in FY 94. However, the balance for unmatched disbursements was \$334 million higher than the yearend result for FY 95. Defense Accounting Service personnel attributed much of the increase to its ongoing consolidation of accounting offices and the resulting personnel turbulence.

Army National Guard. The Army National Guard has identified financial reporting improvement initiatives and recognized the need to review business practices and institute improvements. Some of the planned actions include developing a general ledger reporting process at the State Guard level, and reconciling data reported by State Guard units with consolidated data at the Defense Accounting Service. These initiatives, which the Guard hopes to complete before FY 98, should help resolve some of the Guard's previously discussed reporting problems.

Command-Initiated Adjustments. The Army prepared several financial statement adjustments on its own this year to improve the accuracy of

the FY 96 financial statements. These adjustments were similar to those that we recommended in prior years, and this initiative signifies an enhanced recognition of the need to take ownership of the financial reporting process.

INTEGRATING FUNCTIONAL AND FINANCIAL MANAGEMENT

Here are some of the Army's more significant initiatives aimed at integrating functional and financial management.

Military Personnel and Payroll. The Army and the Defense Accounting Service have developed automated interfaces between the Army's military personnel and pay systems to increase data accuracy and minimize improper payments. The Army has also initiated a process to reduce soldiers' out-of-service debts (debts not collected or settled before soldiers are separated from the Army).

Travel Advances. The Army is emphasizing the collection of outstanding travel advances and the use of government travel cards to reduce the need for advances. Reported travel advances as of 30 September 1996 totaled about \$73 million, a decrease of about 19 percent compared to the total as of 30 September 1995. Also, the Army eliminated retained advances.

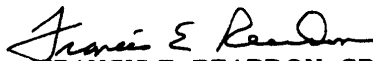
Purchase Card. The Army has increased its use of the International Merchants Purchase Authorization Card (IMPAC) to make micro purchases (generally, purchases under \$2,500). In a recent audit report, we projected that the Army saved the equivalent of \$155 million in workyears in FY 96 by using credit cards instead of purchase orders to execute its micro purchase transactions. An Army team developed specific business practice changes to streamline the purchase card processes which the Army approved in August 1996. These changes should further improve the program's efficiency.

Velocity Management. Velocity Management is a concept, implemented by a coalition of senior Army leaders, that focuses on improving the performance of logistics processes. The goals for this effort are to speed up the supply process, reduce inventories, improve the linkage between supply and financial management systems, and provide managers with timely and accurate decision-making information.

Outlook

The initiatives discussed above are precisely the type of efforts needed to improve financial reporting and integrate functional and financial

management, as intended by the Chief Financial Officers Act. They give evidence both to the Army's commitment to the act and its progress toward successful implementation. Thus, although many problems remain, and full solutions are still several years distant, the outlook is positive.


FRANCIS E. REARDON, CPA
The Auditor General

21 February 1997

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